United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

74-2086

ORIGINAL

To be argued by
GEORGE A. HAHN

In The

United States Court of Appeals

For The Second Circuit

GEORGE FELDMAN, Trustee in Bankruptcy of LEASING CONSULTANTS INCORPORATED, Bankrupt,

Plaintiff-Appellant,

- against -

NATIONAL BANK OF NORTH AMERICA,

Defendant-Appellee.

REPLY BRIEF FOR PLAINTIFF-APPELLANT

HAHN, HESSEN, MARGOLIS & RYAN
Attorneys for Plaintiff-Appellant
350 Fifth Avenue
New York, New York 10001
(212) 736-1000

GEORGE A. HAHN
DANIEL A. ZIMMERMAN
Of Counsel

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UNITED STATES COURT OF APPEALS

For the Second Circuit

Docket No. 74-2086

GEORGE FELDMAN, as Trustee in Bankruptcy of Leasing Consultants Incorporated, Bankrupt,

Plaintiff-Appellant,

-against-

NATIONAL BANK OF NORTH AMERICA,

Defendant-Appellee.

ON APPEAL from the UNITED STATES DISTRICT COURT

For the EASTERN DISTRICT OF NEW YORK

REPLY BRIEF OF PLAINTIFF-APPELLANT

Preliminary Statement

The only real issue in this case is the scope of defendant's chattel mortgage. Any security instrument, regardless of the

label it wears, can grant a lien or security interest only in property owned by the debtor, and only if the instrument reasonably identifies the property in question as being subject to the creditor's lien or security interest. The chattel mortgage, by its own terms, mortgages only the so-called "Mortgaged Property." (A28-29). That instrument defines "Mortgaged Property" as the aircraft and engines described in "Schedule I" and all appurtenances. (A29, A60). Yet it is undisputed that the "Aircraft Lease" between the bankrupt and the Grant Company antedates the chattel mortgage and that defendant was aware of the "Aircraft Lease" when it accepted the mortgage. If the Trustee's contention that the "Aircraft Lease" is a conditional sale contract proves correct, the "Mortgaged Property" did not belong to the bankrupt at the time the mortgage was given; the bankrupt had only a lien or security interest in the airplane sold by it to the Grant Company; and the bankrupt could give the defendant a lien or security interest only in the property owned by the bankrupt, i.e., the bankrupt's security interest in the airplane.

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* The form of the security agreement does not matter. In re Yale Express Systems, Inc., 370 F.2d 433, 437-438 (2d Cir. 1966).

The court need not wonder at defendant's apparent naivete in trying to obtain a security interest in property not owned by its debtor, the bankrupt. A second security instrument was taken by defendant in this transaction, and that instrument, denominated an "Assignment," gave defendant a security interest in the bankrupt's security interest in the airplane.

This is where this case approaches a traditional posture. The litmus test of any security interest is whether it is valid or enforceable against the debtor's trustee in bankruptcy. Under the Federal Aviation Act of 1958, the validity of a security interest related to civil aircraft is dependent upon the filing of the instrument creating the security interest. Because the chattel mortgage was filed while the assignment was not filed, defendant maintains that the chattel mortgage is all encompassing, side-stepping the critical issue of what property is covered by the mortgage.

Point I

THE CHATTEL MORTGAGE DOES NOT GIVE NATIONAL A SECURITY INTEREST IN THE GRANT CHATTEL PAPER*

As a security device, National's chattel mortgage purports to transfer to National a security interest in certain specified property. The words of transfer appear on pages 2 and 3 of the mortgage instrument (A28-29). The transfer paragraph defines the "Mortgaged Property" as "... all of the property described in Schedule I hereto attached, together with" various appurtenances (A29). Schedule I describes the airplane and its engine and nothing more. There is nothing in the collateral description, contained in the chattel mortgage, to indicate that that instrument either gave or was intended to give National a security interest in the Grant chattel paper. (This is perfectly sensible since National obtained a security interest in the chattel paper by a separate instrument received at the same time, which is invalid because National failed to file it for recordation.

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* National acknowledge's that the Grant "Aircraft Lease" as either a conditional sale contract or a true lease would be "chattel paper"under the Code. National's Brief at 4, 40.

A. The chattel mortgage does not create a security interest in the Grant chattel paper, because that security instrument does not reasonably identify the Grant chattel paper as collateral under that instrument.

The court must look to local law to determine the scope and inherent validity of an aircraft conveyance. Federal Aviation Act of 1958 §506, 49 U.S.C. §1406 *; Northern Illinois Corp. v. Bishop Distributing Co., 284 F. Supp. 121 (W.D.Mich. 1968) and the cases cited therein. Thus the New York Uniform Commercial Code determines the sufficiency of the collateral description in the chattel mortgage.

This court's decision in In re Laminated Veneers Co., Inc., 471 F. 2d 1124 (2d Cir. 1973) controls on this issue. In that case the court ruled that "the security agreement embodies the intentions of the parties....", Id., 471 F.2d at 1125, and found that the word "equipment" found in the security agreement did not reasonably describe two Oldsmobile automobiles. The

* 49 U.S.C. §1406 reads: "The validity of any instrument the recording of which is provided for by section 1403 of this title shall be governed by the laws of the State, District of Columbia, or territory or possession of the United States in which such instrument is delivered, irrespective of the location or the place of delivery of the property which is the subject of such instrument. Where the place of intended delivery of such instrument is specified herein, it shall constitute presumptive evidence that such instrument was delivered at the place so specified."

creditor therefor had no security interest in the automobiles.* See also In re Turnage, 493 F.2d 505, 507 (5th Cir. 1974) and In re Stedman, 15 UCC Rep. Serv. 225 (S.D.Fla. 1974)(Referee's Opinion).

As previously pointed out, the collateral description contained in the chattel mortgage gives no hint of an intention by the parties that that instrument give National a security interest in the Grant chattel paper. Recognizing this critical deficiency, National draws on other clauses from the mortgage. But as noted by the Tenth Circuit Court of Appeals in Mitchell v. Shepherd Mall State Bank, 458 F.2d 700, 703 (10th Cir. 1972):

> " 'A long and complex security agreement ... as herein should not have the purpose or effect of concealing a description of the collateral. ... [A]nyone who examines the agreement should not be required to read and interpret all of the fine print at his peril. He would only be interested in the collateral, as clearly designated by the form itself.' In re Radabaugh, 4 UCC Rep. Serv. 355, 357 (S.D.Ohio 1966) (Referee's Opinion)."

In the Radabaugh case, as at bar, the security instrument was lengthy and contained a specific clause defining the collateral

* The decision relies on UCC §9-203(1)(b) which requires that a security agreement contain a description of the collateral.

covered by that instrument. The Referee properly reasoned that: "Under such a form, all of the collateral should be described and included therein ..." Id., 4 UCC Rep. Serv. at 357. The chattel mortgage does not give National a security interest in the Grant chattel paper and the mortgage cannot stand as a bar to the Trustee's recovery of Grant's post-petition payments under the "Aircraft Lease."

B. The rights granted by the Code to a secured party on the debtor's default cannot avail National because such rights apply only to collateral covered by the security instrument involved.

National maintains that the Code provides remedies to a secured party upon the debtor's default. National's Brief at 11-12. This statement is true but misleading. It is misleading because the rights granted by Part 5 of Article 9 of the UCC relate only to collateral in which the secured party has a security interest and as just demonstrated, the chattel mortgage does not give National a security interest in the Grant chattel paper. In other words, the Grant chattel paper is not collateral subject to foreclosure under the chattel mortgage.

National could have foreclosed on the Grant chattel paper if it had filed the "Assignment" for recordation. Filing the chattel mortgage did not accomplish this purpose. There is no valid reason for relieving National from the consequences of its failure to record the instrument which would have given it a perfected security interest in the Grant chattel paper.

In addition, the Code remedies found in Part 5 of Article 9 relate to a secured party's rights against the debtor upon default. Part 2 deals with the validity of security agreements and the rights of the parties to the agreements. Part 3 deals with the rights of third parties. National's position depends on the proposition that:

> "The Trustee stands in the shoes of the Bankrupt to the extent of the Bankrupt's interest in property." National's Brief at 12.

This proposition either misconceives or misrepresents the nature of the Trustee's claims. A §70c trustee sues as a judgment lien creditor of the bankrupt. The Trustee is a third party and his rights vis a vis National are governed by Part 3 of Article 9 rather than Part 5. But it is even more fundamental to the case at bar that a determination of whether the

chattel mortgage gives National a security interest in the Grant chattel paper is governed by Part 2, and not by Part 5, or any of the sections thereunder. When National's bland assertions that the chattel mortgage gives it a perfected security interest in Grant's payments under the chattel paper are carefully scrutinized, the deficiencies of National's position become all too clear. Part 5 of Article 9 is irrelevant to the issues at bar.

C. Since the bankrupt had only a security interest in the airplane when the chattel mortgage was executed and the chattel mortgage did not purport to give National a security interest in the bankrupt's security interest, the chattel mortgage does not give National a security interest in the airplane.

Based solely on the fact that the chattel mortgage does not give National a security interest in the Grant chattel paper, and regardless of whether the "Aircraft Lease" is a conditional sale contract or true lease, the Trustee is entitled to recover the $440,562.50 in post-petition payments made by Grant to National pursuant to the assigned "Aircraft Lease," as per the Trustee's first cause of action. The proper outcome for the second cause of action depends in part on

whether the "Aircraft Lease" is a conditional sale contract.

As detailed in the Trustee's initial brief, if the "Aircraft Lease" is a conditional sale contract, the bankrupt as lessor/vendor had only a security interest in the airplane, while Grant as lessee/vendee was the owner/debtor. What property did the bankrupt then have to give National as collateral security for the $500,000.00 loan? The bankrupt had only the chattel paper, i.e. Grant's monetary obligation under the "Aircraft Lease" and the bankrupt's security interest in the airplane to secure payment of that obligation. The "warranty of title" found at Section 3.1 of the chattel mortgage (A35) was false. Since the only collateral covered by the chattel mortgage was the airplane and since the bankrupt did not own the airplane at that time, the bankrupt had no "rights in the collateral" and National's purported security interest in the airplane never attached. U.C.C. §9-204(1). This, in effect, renders the chattel mortgage totally ineffective as a security instrument.

If on the other hand, the "Aircraft Lease" is treated as a true lease, the court must allocate the $433,705.58 in pro-

ceeds under the stipulation between the balance of Grant's chattel paper obligation and the value of the lease reversion. The proceeds were made up of $372,890.16 constituting the discounted value of the remaining thirty-nine lease payments, leaving $60,815.42, the discounted option price, as the value of the lease reversion. The Trustee should get judgment on his second cause of action for $99,658.02 of the escrowed fund under this alternative.

Point II

THE GRANT LEASE IS A CONDITIONAL SALE CONTRACT

National admits "that a document in the form of a lease is deemed a conditional sale contract ... if the lease rentals constitute compensation substantially euqivalent to the value of the aircraft, and if the lease is accompanied by an option." National's Brief at 34, 35. Indeed the statutory definition, 49 U.S.C. §1301(16)(b), speaks of whether the lessee "has the option of becoming the owner" of the airplane.

While the record shows without contradiction that the Grant Company had the option of becoming the owner of the aircraft (A12, A80), National nevertheless denies that the lease was a conditional sale contract because even though there was a written option, the option was not filed with the Administrator and National was unaware of its existence. *

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* National's "actual knowledge" of the option or of inquiry provoking facts regarding the existence of the option, if relevant, is a fact question reserved by the Trustee in his Rule 9(g) statement (A47).

National's Brief at 34-35. The unstated rationale of National's assertion is that the "option" is a "conveyance" invalid as against National under 49 U.S.C. §1403(c). But National's position clearly begs the issue. The statutory definition asks only whether the lessee "has" an option, not whether the option is valid against third parties to the transaction such as National. Under 49 U.S.C. §1403(c) the option, if indeed a "conveyance," was valid against the bankrupt even though unfiled. As between the parties, the "Aircraft Lease" was a conditional sale contract.

Looking to state law for an analogy, it is the existence of the option that turns the lease into a security device, not any third party's knowledge of its existence. See U.C.C. §1-201(37) and the Official Comment thereto. This court has previously held that it will examine all factors to determine whether a lease is a security device. In re Leasing Consultants Inc., 486 F.2d 367, 373 (2d Cir. 1973). See also In re Walter Willis, Inc. 313 F. Supp. 1274, 1278 (N.D.Ohio 1970), aff. 440 F.2d 995 (6th Cir. 1971). At bar the option exists and National's position is nothing more than a "red herring." The Grant lease is a conditional sale contract.

Point III

THE TRUSTEE HAD NO ACTUAL NOTICE OF THE ASSIGNMENT

The Trustee's initial brief, pages 20-23, demonstrates that a §70c trustee is deemed to be without "actual notice." Without an attempt to distinguish this court's prior decisions to that effect, National takes the incredible position that the expression "actual notice" as used by Congress in 49 U.S.C. §1403(c) does not mean "actual notice" at all. National's conclusion is that Congress really meant to say "constructive notice." Thus National argues:

> "The term 'actual notice' found in the FAA and its predecessor the Ship Mortgage Act, 46 U.S.C.A. §911 et seq. is not a usual one. It blurs the customary distinction between actual knowledge and contructive notice from a recording system...." National's Brief at 28.

This assertion is incredible. The difference between actual and constructive notice is of long standing. In The Tompkins, 13 F.2d 522 (2d Cir. 1926), a case relied upon by National and decided under the Ship Mortgage Act, this court recognized the distinction between actual and constructive notice, id., 13 F. 2d at 554, and found actual notice where the party's counsel had actually reviewed a recorded document which revealed the

existence of the unrecorded conveyance. Id., 13 F.2d at 554. The Trustee, as a hypothetical creditor, did not review the record prior to petition filing, so that the references to the unfiled assignment found in the filed mortgage were not part of his knowledge.

Construing 49 U.S.C. §1403 as a whole it is obvious that "actual notice" means "actual notice." While subsection(c) declares the unfiled conveyance invalid against third persons without "actual notice," subsection(d)* declares the validity of all conveyances actually filed for recording. Thus constructive notice, i.e. "that notice which a person is deemed to have by operation of law, commonly through recording statutes,"** is not part of the statutory scheme, because the recorded conveyance is expressly valid without recourse to the

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* 49 U.S.C. §1403(d) reads: "Each conveyance or other instrument recorded by means of or under the system provided for in subsection (a) or (b) of this section shall from the time of its filing for recordation be valid as to all persons without further or other recordation...."

** Sands v. United States, 198 F. Supp. 880, 884 (W.D. Wash. 1960).

legal fiction of constructive notice. This construction is in accord with U.C.C. §9-301, and the pre-Code decisions of this court cited by the Trustee in his initial brief, where to charge the trustee with knowledge of the contents of the record would have barred the trustee's recovery. The trustee in those cases was not charged with "actual notice" and the same result follows for the case at bar.

Point IV

THE TRUSTEE HAS STANDING TO INVALIDATE THE ASSIGNMENT

National maintains that §503c, 49 U.S.C. §1403c, protects only bona fide purchasers and encumbrancers, and does not benefit the trustee "as an execution or attachment creditor" of the bankrupt. National's Brief at 45-48. This is not borne out by the statutory language, or the rules governing the lien of an attachment or execution creditor.

The language of Federal Aviation Act §503c, 49 U.S.C. §1403c, is clear and unambiguous. It declares an unrecorded conveyance invalid

> "... against any person other than the person by whom the conveyance or other instrument is made or given, his heir or devisee, or any person having actual notice thereof..."

A judgment lien creditor normally prevails over the holder of an unperfected security interest in personalty. In the United States, the bulk of priority disputes over personalty between the holders of unperfected security interests and judgment lien creditors are decided under Article 9 of the Uniform Commercial Code. U.C.C. §9-301 leaves no doubt about the priorities between a judgment lien credi-

tor and the holder of an unperfected security interest:

> "(1) Except as otherwise provided in subsection (2), an unperfected security interest is subordinate to the rights of ...
>
> "(b) a person who becomes a lien creditor without knowledge of the security interest and before it is perfected."

Subsection (2) deals with purchase money security interests and is not applicable at bar. "Lien creditor" is also defined in that section.

> "(3) A 'lien creditor' means a creditor who has acquired a lien on the property involved by attachment, levy or the like and includes ... a trustee in bankruptcy from the date of the filing of the petition .... Unless all the creditors represented had knowledge of the security interest such a representative of creditors is a lien creditor without knowledge even though he personally had knowledge of the security interest."

Thus if National's chattel paper security interest is invalid or unperfected, and the Code determined the priorities between the Trustee and National, the Trustee would prevail. The same is true under pre-Code statutes dealing with various forms of security devices. See Fifth Third Union Trust Co. v. Kennedy, 185 F.2d 833 (2d Cir. 1950); Hoffman v. Cream-O-Products, 180 F.2d 649 (2d Cir. 1950), cert. den. 340 U.S. 815 (1950); Empire State Chair Co. v. Beldock, 140 F.2d 587 (2d Cir. 1944), cert. den. 322 U.S. 760 (1944); White v. Steinman, 120 F.2d 799 (2d Cir. 1941), cert. den. 314 U.S. 657 (1941).

The rights of a judgment lien creditor to a debtor's personal property are therefore superior to the rights of the holder of an unperfected security interest in that property. That being the case, there can be no doubt but that the trustee can enforce his superior posture in the courts. In light of this history, if Congress had intended to achieve a different result by enacting §503c, it would have chosen appropriate language. There are statutes under which a judgment lien creditor cannot invalidate an unrecorded mortgage. New York Real Property Law ("RPL") §291, cited to the court by National (National's Brief at 26), is such a statute. See United States v. Certain Lands, 44 F. Supp. 830, 832 (E.D.N.Y. 1972); United States v. Certain Lands, 41 F. Supp. 636, 637 (E.D.N.Y.1971); Trenton Banking Co. v. Duncan, 86 N.Y. 221 (1881). The operable statutory language appears below.*

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* RPL §291 provides, inter alia: "Every such conveyance not so recorded is void as against any person who subsequently purchases or acquires by exchange or contracts to purchase or acquire by exchange, the same real property or any portion thereof, or acquires by assignment the rent to accrue therefrom ... in good faith and for a valuable consideration, from the same vendor or assignor, his distributees or devisees, and whose conveyance, contract or assignment is first duly recorded...".

Congress' failure to clearly limit the benefit of §503c to subsequent purchasers, assignees, mortgagees and like persons, to the exclusion of judgment lien creditors, indicates that such a limitation was not intended. By use of the language "any person other than..." and then specifically defining those excluded, Congress made manifest that "any person" encompasses everyone not falling within the excluded class, and therefore includes judgment lien creditors. In construing a similar phrase the Court of Appeals for the Fourth Circuit stated that the term "...'third parties without notice' includes subsequent creditors, whether lien creditors or not." Friedman v. Sterling Refrigerator Co., 104 F.2d 837, 840 (4th Cir. 1939). The Trustee, as a lien creditor, certainly has standing to maintain this suit.

Point V

THE SUIT IS TIMELY

In Feldman v. First National City Bank, 368 F. Supp. 1333 (S.D.N.Y. 1974), District Judge Bauman decided, on the very same cause of action, that the six year statute of limitations found at New York CPLR §213(1) governed the trustee's cause of action to invalidate the chattel paper assignment and recover the post-petition receipts thereunder. That decision follows a long line of precedent. See MacLeod v. Kapp, 81 F. Supp. 512, 513 (S.D.N.Y. 1948); Halpert v. Engine Air Service, Inc., 116 F. Supp. 13, 15 (E.D.N.Y. 1953); Schutte v. Wittner, 149 F. Supp. 451, 452 (E.D.N.Y. 1957); Harrington v. Yellin, 158 F. Supp. 456, 458-459 (E.D.Pa. 1958); Priebe v. Svehlek, 245 F. Supp. 743, 745 (E.D.Wis. 1965); Buchman v. American Foam Rubber Corp., 250 F. Supp. 60, 65, 71 (S.D.N.Y. 1965). See also Hummel v. Equitable Life Assur. Soc. 151 F.2d 994, 997 (7th Cir. 1945) and McBride v. Farrington, 60 F. Supp. 92 (D.Ore. 1945), aff. 156 F.2d 971 (9th Cir. 1946).

Judge Bauman's decision in the Citibank case is presently on appeal to this court, docket number 74-1893, and this legal

issue is briefed extensively by the Trustee at Point IV of his Appellee Brief. The Trustee will not burden the court with a repetition of the extensive legal argument appearing there, but respectfully refers the court's attention to that Brief.

Under the six year statute of limitations, or even a three year limitation period, the suit was timely.*

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* While the suit was commenced on January 31, 1974 (A1), more than three years after adjudication and petition filing, National acknowledges that the statute of limitations was tolled effective January of 1973. National's Brief at 43, 44.

CONCLUSION

THE JUDGMENT BELOW SHOULD BE REVERSED AND JUDGMENT ENTERED IN FAVOR OF PLAINTIFF-APPELLANT.

Respectfully submitted,

HAHN, HESSEN, MARGOLIS & RYAN
Attorneys for Plaintiff-Appellant
350 Fifth Avenue
New York, New York 10001

George A. Hahn,
Daniel A. Zimmerman,

Of Counsel.

A 202 Affidavit of Personal Service of Papers H LUTZ APPELLATE PRINTERS INC.

US COURT OF APPEALS: SECOND CIRCUIT

FELDMAN,
Plaintiff-Appellant,

against

NAT'L BANK OF N.A.
Defendant-Appellee,

Index No.

Affidavit of Personal Service

STATE OF NEW YORK, COUNTY OF NEW YORK ss.:

I, James Steele, being duly sworn,

deposes and says that deponent is not a party to the action, is over 18 years of age and resides at

250 West 146th Street, New York, New York

That on the [redacted] 13th day of December 1974 at 40 Wall Street, New York

deponent served the annexed Appellant's Brief upon

Coel & [redacted]Deitz, Esqs.

the in this action by delivering 2 true copy thereof to said individual personally. Deponent knew the person so served to be the person mentioned and described in said papers as the Attorney(s) herein,

James Steele

Print name beneath signature

JAMES STEELE

Sworn to before me, this [redacted] 13th day of December 1974

Robert T. Brin

ROBERT T. BRIN
NOTARY PUBLIC, STATE OF NEW YORK
NO. 31 - 0418950
QUALIFIED IN NEW YORK COUNTY
COMMISSION EXPIRES MARCH 30, 1975